Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Wesson, et. Al. | Analyst: Marion Mann DeJong | Bill Number: AB 2747

Related Bills: See Legislative History | Telephone: 845-6979 | Amended Date: 04/18/02 & 04/30/02

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Motion Picture Production Wages Paid Credit

SUMMARY

This bill would create an income tax credit for wages paid in connection with the production of a motion picture in California. If unable to use this credit, the taxpayer could:

- assign the credit to another taxpayer;
- apply the income tax credit against any sales or use taxes owed; or
- receive a refund of any sales or use taxes paid.

SUMMARY OF AMENDMENTS

The April 18, 2002, amendments deleted the declaration of legislative intent to provide a television or movie production tax credit and inserted the credit language provisions summarized above.

The April 30, 2002, amendments changed the dollar amount in the cost of living adjustment to match the dollar limit that it is adjusting and added a provision allowing wages paid on or after January 1, 2004, but before July 1, 2004 to qualify for the credit.

PURPOSE OF THE BILL

According to the sponsor, the purpose of this bill is to stem run-away film production by providing a tax incentive to produce motion pictures in California.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. However, the bill specifies that it would be operative for taxable years beginning on or after July 1, 2004, and before January 1, 2010.

POSITION

Pending.

Board Position:			Department Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR	Alan Hunter for GHG	5/13/02
____ N	____ OUA	__X__ PENDING		

Summary of Suggested Amendments

Amendments are needed to resolve the department's implementation concerns. See "Implementation Considerations" below. Department staff is working with the author, sponsor, and Governor's office to resolve these concerns.

ANALYSIS

FEDERAL/STATE LAW

Current state and federal laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business (e.g., employee wages and benefits).

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Under the Government Code, existing state law authorizes the Technology, Trade, and Commerce Agency (TTCA) to designate 42 enterprise zones. Currently, 39 are designated. Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within an enterprise zone. These incentives include a sales or use tax credit, hiring credit, business expense deduction, special net operating loss treatment, and net interest deduction. The purpose of these incentives is to stimulate growth and development in depressed areas.

Under existing state and federal laws, generally only the taxpayer that incurred the credit-related expense may claim tax credits. In the case of the low-income housing credit, if a property is acquired during the credit period, the credit may be transferred to the acquiring taxpayer. In addition, for state purposes, a specific statutory authorization permits the low-income housing credit under the California Tax Law to be transferred between wholly owned affiliated corporations.

Existing federal law allows members of an affiliated group to file a consolidated income tax return. Members of an affiliated group that file a consolidated return are jointly and severally liable for the tax liability on the consolidated return. Credits can be shared among the members of the group that file the consolidated return since the group is considered one taxpayer. However, an affiliated group is not necessarily the same group of corporations as a unitary group for state purposes. Under state law all members of the combined group must satisfy the tests of unity during the year. For state purposes, members of a unitary group combine all unitary business income using a combined report when determining California-source income. Generally, a taxpayer included in a combined report must file its own tax return. However, some unitary groups may elect to file a group return and report the sum of the separate tax liabilities of the unitary members. Unlike taxpayers that file a federal consolidated return, a taxpayer within the combined report is not jointly and severally liable for the tax liability of every other member within the combined group.

In addition, a taxpayer in a combined group is subject to the California tax on the basis of all of its income from California sources. This can include income from an apportioning unitary trade or business activity, a wholly-owned apportioning trade or business activity, a trade or business activity conducted wholly within California, and non-business income from California sources. The tax is computed on the basis of the total amount of each of these components. Any credit is applied to that tax amount.

THIS BILL

This bill would create an income tax credit equal to a percentage of wages paid in relation to the production of a motion picture in California.

The credit would equal 15% of wages paid to qualified individuals during the taxable year with respect to a motion picture. For qualified individuals in a motion picture located in an enterprise zone, the credit would equal 25% of wages paid to qualified individuals during the taxable year with respect to that motion picture. For each motion picture, the maximum amount of wages per qualified individual that can be taken into account in computing the credit is $25,000.

"Qualified individuals" would be individuals who render personal services in an activity related to the production of a motion picture. Individuals related to the taxpayer would not qualify for the credit. To qualify, the individual must perform substantially all of his or her services during the year in an activity related to a motion picture that qualifies for the credit.

Wages qualifying for the credit would include:

- Compensation paid to an employee on or after January 1, 2004, for services performed in California while the employee is a qualified individual.
- Employee fringe benefit expenses that are allocable to services performed in California.
- Payments made to an entity (i.e., personal service corporations, payroll service corporation, or any entity receiving wages on behalf of a qualified individual) on or after January 1, 2004, for services performed in California by qualified individuals.
- Compensation paid to independent contractors on or after January 1, 2004, who are qualified individuals for services personally rendered in California.

Cost paid for various activities specified in the bill that are unrelated to the production of a motion picture would be excluded from wages that qualify for the credit.

Motion pictures qualifying for the credit would be motion pictures as defined in Section 6010.6(b)(3) of the Revenue and Taxation Code (the sales and use tax law) that meet both of the following additional requirements:

- The total cost of wages of the motion picture, excluding specific costs, is more than $200,000, but less than $10 million. These amounts will be indexed for inflation. For purposes of this test, each episode of a television series is considered to be a separate motion picture.

- 50% of the total wages of the production are wages that qualify for the credit.

If the qualified wages under this section also qualify for a different income tax credit, the taxpayer could claim only this credit for the wages paid to any employee and not the other income tax credit.

The taxpayer may elect to assign any portion of this credit to members of the same controlled group. Excess credit amounts could be carried forward indefinitely. Alternatively, the taxpayer could elect to apply the income tax credit against a sales or use tax liability or request a refund of sales or use tax already paid equal to the income tax credit.

IMPLEMENTATION CONSIDERATIONS

The department would be unable to administer this bill as currently drafted. Department staff has identified numerous implementation concerns for this bill. The following is a brief discussion of the most significant issues. Additional issues may be identified as the bill is refined and moves through the legislative process.

- Taxpayers and the department would have difficulty determining if a motion picture qualified the taxpayer for the credit. The credit is based on a percentage of wages paid during the taxable year with respect to a “qualified motion picture production.” To be a qualified motion picture, the *total* cost of wages of the motion picture must meet certain dollar limits and 50% of the *total* wages of the production must be incurred for services performed in California. Taxpayers and the department would not be able to determine if a motion picture was a “qualified motion picture” until the production was complete. The period for production could cross several taxable years and therefore require the filing of amended returns to claim the credit (if the statute of limitations remains open for the year the expenses were incurred). In addition, more than one taxpayer could be involved with the production of a motion picture. Unless the taxpayers were required to share the wage information with each other and the department, it would be difficult to determine if the wage limitations were met and the motion picture qualified. Moreover, unless taxpayers were required to share this information with one another, disclosure issues would arise if the department sought to challenge qualification for the credit for one taxpayer where the disallowance was based on confidential tax information obtained from another taxpayer during the course of audit.

- The bill could allow more than one taxpayer to qualify for the same wage expense payment due to the broad definition of "qualified wages" under the bill. For example, if the producer pays a subcontractor for the services of the subcontractor’s employees, and the subcontractor in turn pays its own employees, this bill could allow a credit to both the producer and the subcontractor with respect to their "wage" payments. According to the sponsor of the bill, only the producer should qualify for the credit. It is suggested that the bill be amended to reflect the author’s intent in this regard.

- “Qualified wages” includes “compensation” and “fringe benefits.” Compensation generally includes “fringe benefits.” “Wages” may be more appropriate than “compensation.” Further, it is unclear whether all fringe benefits or a portion of fringe benefits would be considered “qualified wages.” Unclear provisions can lead to disputes between taxpayers and the department.

- The bill is internally inconsistent and would not provide the author's intent of allowing wages paid on or after January 1, 2004, to qualify for the bill. Although the definition of "qualified wages" specifies that wages paid on or after January 1, 2004, the credit is 15% of wages paid during the taxable year. The credit is available for taxable year beginning on or after July 1, 2004. Thus, wages paid from January 1, 2004, June 30, 2004 would not qualify. It is suggested that the bill be amended to reflect the author's intent in this regard.

- It is unclear whether the increased credit for enterprise zones would be 25% or 40% (15% plus 25%) of wages. Further, it is unclear what is meant by a motion picture "located" in an enterprise zone. This could mean the picture must be filmed in the zone, or the services for which wages are paid must be performed in the zone. It is also unclear whether all activities or only a majority of activities must be located in the zone.

- This bill allows the credit to be assigned to any member of a commonly controlled group. It's unclear what limitations, if any, would be applicable regarding this assignment among members of a commonly controlled group.

  For example, it is unclear what would happen if a taxpayer assigns a credit and the credit is partially or completely disallowed in a subsequent audit by the department. The bill should clarify the department's legal authority to adjust the tax liability of the assignee and reclaim the credit amount, with interest, from the assignee, especially if the assignor is either no longer in existence or no longer subject to California's taxing jurisdiction. Moreover, since there may be occasion where the department's audit of the assignor taxpayer's return may occur after normal expiration of the statute of limitations (i.e., under a waiver), it might become necessary for the department to request waiver of the assignee's statute of limitations to prevent the department from being foreclosed from adjusting the assignee's tax liability when the department determines that part or all of the claimed credit should never have been allowed. Further, the department would need to be specifically authorized to disclose the necessary confidential tax information of the assignor to the assignee if such situation arose. Conversely, the assignee would statutorily need authorization to obtain tax information from the assignor about the circumstances surrounding their claiming of the credit that was assigned in order to defend a subsequent proposed adjustment by the department.

  Alternatively, if the claimed credit of the assignor is disallowed only in part, it is unclear how this disallowance would be allocated between the assignor and the assignee, especially if the statute of limitations has expired for one, but not both, of the affected taxpayers.

  The provision that allows the credit under the Personal Income Tax Law (PITL) to be assigned to one or more taxpayers is ineffective. The bill limits the assignment to other taxpayers in a controlled group of corporations. Individuals cannot be members of a controlled group of corporations. Furthermore, corporations are not subject to the PITL. Consequently, only a taxpayer subject to the PITL can use any credit against the tax imposed under the PITL.

  The bill does not specify when the assignee taxpayer can use the assigned credit. It could be used in the same year as the assignor earned the credit or it could be used in the taxable year succeeding the taxable year of assignment and subsequent taxable years, similar to a carryover.

A commonly controlled group is not necessarily the same as a unitary group if the tests of unity are not satisfied during the year. The bill does not specify how the assignment would occur in this case. In addition, the bill does not specify what would happen if a member subsequently entered or left the group.

- This bill would create a system of "California tax benefit transfers" similar to the old federal safe harbor leasing regime. However, tax credits transferable under federal safe harbor leasing rules were limited to tax credits for the purchase of certain property and the transfer was accomplished by a nominal sale-leaseback of that property that thereby defined the tax consequences of the tax benefit transfer as between related parties. This credit is based on wage expenses. In the absence of clarification, disputes may arise between taxpayers and the department as to the proper tax treatment of consideration paid in connection with the transfer of a credit under this bill.

- The mechanics of the election should be refined to require a formal election on an originally filed return in the form and manner prescribed by the Franchise Tax Board in forms and instructions.

- The bill allows a taxpayer to elect to apply the income tax credit against a sales or use tax liability or request a refund of sales or use tax already paid equal to the income tax credit. However, the bill does not specify what is to be done if the income tax credit is partially or completely disallowed in a subsequent audit by the department. Further, the sales and use tax refund provision refers to the Board of Equalization's authority to recover any "erroneous" refund, but it is unclear whether a determination by the department would constitute an "erroneous" refund within the meaning of the law administered by the Board of Equalization. The bill should specify how the income tax credit and the election to receive a sales tax refund are intended to be coordinated. In addition, the bill should specify which agency (the department or the Board of Equalization) is to make the determination of whether a sales or use tax refund that has been granted is considered "erroneous" and thus capable of recovery through the sales tax "erroneous" refund authority.

- The definition of qualified individual does not work as the author intends. The definition requires “substantially all” of the individual’s activities performed to be in relation to a qualified motion picture. First, the term "substantially all" is not defined, and thus the department is unsure as to when this standard would be satisfied. Second, if an actor worked on three films during the year, one in California that meets the requirements to be a “qualified motion picture” and the other two films in Canada, none of that actor’s wages could be included in the credit computation since the "substantially all" standard would clearly not be met. If the same actor only worked on two films, one in California and one in Canada, the lack of a definition for "substantially all" would make it difficult to determine if that actor's wages could be included in the credit computation. As a result, it appears that the term “substantially all” should simply be removed from the definition.

- The definitions in this bill use terms and phrases that appear to be industry-specific, e.g. “new-use,” “reuse,” “clip use,” “delayed or residual compensation,” “turnaround,” etc. If there is a “dictionary” of motion picture industry terms, it might be helpful to identify a specific source for these terms and to specifically tie the interpretation of these terms under this bill to those external sources by explicit cross-references within the bill.

- This bill does not limit the number of years for the carryover period. The department would be required to retain the carryover on the tax forms indefinitely because an unlimited credit carryover period is allowed. Recent credits have been enacted with a carryover period limitation since experience shows credits typically are exhausted within eight years of being earned. Further, due to the assignment and refund provisions in this bill, a long carryover period may be less necessary than in other similar credit provisions.

TECHNICAL CONSIDERATIONS

Department staff had identified the following technical considerations. Additional issues may be identified as the bill is refined and moves through the legislative process.

- SB 1185 (Senate Revenue and Taxation Committee, Stats. 2001, Ch. 543) renamed the “Bank and Corporation Tax Law” as the “Corporation Tax Law.” Amendment 1 would delete “Bank and” from the reference to the corporation tax return.

- Amendment 2 would change an incorrect reference from Section 17309 to Section 17039.

- The bill specifies a repeal date of December 31, 2010. However, the credit in this bill is for calendar and fiscal years beginning before January 1, 2010. In order to retain the provisions "in law" until the day after the last day of the fiscal year beginning December 1, 2009, this date should be December 1, 2010. Amendments 3 and 4 would correct this repeal date.

- The purpose of subdivision (h) is unclear, but appears to prevent the taxpayer from claiming more than one credit. Since subdivision (f) already makes this restriction, subdivision (h) appears to be unnecessary. In addition, it should be noted that subdivision (f) would require taxpayers to claim this credit and forgo any other wage credit available, regardless of which credit is more beneficial to the taxpayer.

LEGISLATIVE HISTORY

AB 1062 (Battin, 1997/1998) would have expanded the Manufacturers’ Investment Credit to allow the credit for costs associated with certain activities relating to teleproduction and other postproduction services. AB 1062 was later amended to provide a sales or use tax exemption for teleproduction and other postproduction property. AB 1062 died because it failed to pass to the second house by the constitutional deadline.

AB 484 (Kuehl, 1999/2000) as amended July 14, 1999, would have provided a refundable income tax credit for wages paid in connection with the production of or musical scoring for certain television programs or motion pictures. As enacted, AB 484 (Stats. 1999, Ch. 699), created the Film California First Program within the Trade and Commerce Agency to assist in the underwriting of actual costs incurred by production companies filming in California.

AB 358 (Wildman, 1999/2000) would have provided a refundable income tax credit for wages paid in connection with television programs or motion pictures similar to AB 484. AB 358 was held in the Senate Appropriations Committee.

SB 1366 (Kuehl, 2001/2002) is a spot bill that, according to the author's office, is intended to address the entertainment industry. SB 1366 is in the Senate Rules Committee.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws do not provide a credit comparable to the credit allowed by this bill. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

Congress is considering two bills, Senate bill 1278 and House Resolution 3131, that would provide a credit equal to 25% of the first $25,000 of labor costs incurred for the production of motion pictures in the U.S.

Canada provides a refundable income tax credit for a percentage of Canadian labor costs related to motion picture production. Additionally, most Canadian provinces provide a similar credit that matches the national credit. The two credits can equal up to 22% of Canadian labor costs.

Hawaii provides an income tax credit of up to 4% of cost incurred in Hawaii for production of motion pictures and television series. Currently, the Hawaiian legislature is considering a bill, SB 3021, to allow an income tax credit equal to 22% of wages and salaries paid to motion picture and television workers for productions made in Hawaii.

New Mexico is considering a bill, HB 118, which would provide a refundable tax credit equal to 15% of direct production expenses of films made in New Mexico.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved, but are anticipated to be significant.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

The revenue impact of this bill is estimated to be as shown in the following table:

Revenue Impact of AB 2747, As Amended April 30, 2002 Effective July 1, 2004 $ Millions			
2003-04	2004-05	2005-06	2006-07
-$0	-$15	-$100	-$100

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The revenue impact of this credit would depend on the amount of qualified wages paid beginning on July 1, 2004, and through November 30, 2010. Qualified wages is estimated as the product of the number of employees in the film/video industry, the average weekly wage, the number of work-weeks per year, and an adjustment factor which accounts for the loss of deductions due to this credit, the $25,000 wage cap, and the $10 million production cost cap.

The amount of qualified wages for the 2005 tax year is projected to be $635 million derived as follows:

> 23,686 qualified employees X $1407 Average Weekly Wage X 50 Weeks X 0.38 Adjustment Factor
> = $635 million qualified wages

The adjustment factor of 38% includes the loss of deductions due to this credit, the $25,000 wage cap, and the $10 million production cost cap.

The amount of credit generated for the 2005 tax year is projected to be $95 million as follows:

> $635 million qualified wages X 15% credit rate = $95 million

This amount of generated credit is further adjusted for credit utilization rates by corporations and for cash-flow reductions in estimated tax payments throughout the year to arrive at the fiscal year estimates above.

The Film and Television Action Committee (FTAC) provided an estimate for the amount of wages that would qualify under this bill. For the year 1998, FTAC estimates that total wages for qualified projects would be approximately $1,429 million, about 12% of the wages paid to California employees in industry SIC 781 (Motion Picture and Video tape Production). Based on the weekly wage data $1292 from EDD, employment in qualified projects is estimated at 22,124 persons. This level of employment is assumed to stay unchanged from 1998 to 2002. From 2002 onward, employment is assumed to grow at 2.3% annually. Average weekly wages for the future years are assumed to grow at the same rates as Consumer Price Index.

This estimate did not include wages paid from January 1, 2004, to June 30, 2004. If the bill is amended to reflect the author's intent to allow these wages, the revenue loss could increase by as much as $80 million spread over fiscal years 2004-05 to 2006-07.

ARGUMENTS/POLICY CONCERNS

- This bill allows the credit to be used by any member of a commonly-controlled group, irrespective of whether that group is a unitary group or not. Under existing state law, credits are only available to the taxpayer that incurred the expense that provided the basis for the credit. Only the low-income housing credit permits a corporation to assign all or a portion of its low-income housing credit to one or more affiliated corporations and only under extremely narrow circumstances (100% common ownership). Furthermore, the Governor vetoed legislation (AB 1903, Lowenthal, 1999/2000) that would have allowed the low-income housing credit to be used by taxpayers with no economic responsibility for the expenses that provided the basis for that credit.

The sponsor of the bill suggests that the credit should be shared; similar to how it would be done for federal consolidated return purposes. However, as discussed earlier in this analysis, California law does not allow the filing of consolidated returns by affiliated corporations. Instead, affiliates that file a combined report retain their separate tax identity and liability for only their own taxes. Generally, items such as net operating loss carryovers and credits are not shared among the members of the combined group. If state tax policy is to be changed to allow this credit to be applied against the tax liability of other members of the combined group, perhaps a similar change in state tax policy should be considered for all credits.

Some who support the policy of a combined group's use of credits have done so using the rationale that the investment that gave rise to the credit is economically a group investment. That rationale would support apportionment of credits to *all* members of the combined group, even those that are not California taxpayers.

- It may be more efficient and probably easier administratively for the department to provide a refundable income tax credit rather than a credit that can be assigned to another taxpayer or indirectly refunded via the sales or use tax.

- This credit is indirectly refundable via the sales and use tax refund portion of the bill. Historically, refundable credits (such as the state renter's credit, the federal Earned Income Tax Credit, and the federal farm gas credit) have had significant problems with fraud. These problems may be further exacerbated because this credit would be earned under the income tax laws, administered by the Franchise Tax Board, and refunded under the sales and use tax laws, administered by the Board of Equalization.

- This bill could be considered inequitable to some taxpayers because taxpayers with fiscal years beginning between July 1 and December 1 would be eligible for the incentive for seven taxable years while those with fiscal years beginning between January 1 and June 1 would be eligible for the incentive for only six taxable years.

- Conflicting tax policies come into play whenever a credit is provided for an expense item for which preferential treatment is already allowed in the form of an expense deduction. This bill would have the effect of providing a double benefit for deductible wages and salaries. On the other hand, making an adjustment to limit deductions or reduce basis in order to eliminate the double benefit creates a state and federal difference, which is contrary to the state's general conformity policy.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2747
As Amended April 30, 2002

AMENDMENT 1

On page 2, line 14, strikeout "bank and"

AMENDMENT 2

On page 3, line 22, strikeout "17309" and insert:

17039

AMENDMENT 3

On page 6, line 30 strike out "31" and insert:

"1"

AMENDMENT 4

On page 10, line 14 strike out "31" and insert:

"1"